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No. 06-1457

IN THE

# Supreme Court of the United States

MORGAN STANLEY CAPITAL GROUP INC.,
*Petitioner,*

v.

PUBLIC UTILITY DISTRICT NO. 1
OF SNOHOMISH COUNTY WASHINGTON, *et al.*,
and
FEDERAL ENERGY REGULATORY COMMISSION,
*Respondents.*

**On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

## REPLY BRIEF FOR PETITIONER

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## REPLY BRIEF FOR PETITIONER

For the past fifty years, participants in the wholesale energy market have assumed that a valid agreement – *i.e.*, an agreement that conforms with the ordinary principles of contract law – entered into by sophisticated parties is necessarily "just and reasonable" (16 U.S.C. § 824) and thus may not be disturbed except in those rare instances where the Federal Energy Regulatory Commission ("FERC") determines that the contract is causing extraordinary damage to the public interest. Prior to 1956, FERC administered a traditional scheme of filed-rate administrative pricing. Pet. at 13. This Court's unanimous landmark rulings in *United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332 (1956), and *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956), however, held that "preserving the integrity of contracts" was "essential to the health of the [power industry]." 350 U.S. at 344. In the half century since *Mobile* and *Sierra*, FERC has consistently emphasized the importance of "preservation of contracts" to the energy markets. Pet. at 6, 8.

Until now. In this case, sophisticated parties (petitioner and respondent) entered into a valid long term agreement concerning wholesale energy. Respondent sought to undo the deal more than a year after the agreement was signed primarily citing the "market dysfunction" in the separate market for short term ("spot") energy, a dysfunction that was well known to both respondent and petitioner when they executed this contract. FERC properly sustained the contract because it was the result of a "bona fide arm's-length transaction[] between knowledgeable companies." Pet. App. at 220a. Nevertheless, over FERC's objection, the Ninth Circuit remanded the matter to FERC so that it could decide whether to undo this valid contract. Evidently content with FERC's new discretion to undo

negotiated contracts, the Solicitor General states that review by this Court would be premature.[1] U.S. Opp. at 12, 25.

Thus, once again, this Court must grant review to halt FERC's adoption of an administrative pricing scheme that does not respect the integrity of contracts. Nothing the agency can do on remand can mute the direct message that the Ninth Circuit has sent to the energy markets: Every wholesale energy contract is potentially subject to post-hoc invalidation by FERC acting on its own or under the command of the Ninth Circuit. The decision below is in direct conflict with *Mobile* and *Sierra*, as well as circuit court cases. Moreover, the case is of tremendous importance to participants in the wholesale energy market. Review is essential now.

## I. THE *MOBILE-SIERRA* DOCTRINE FORBIDS FERC FROM MODIFYING VALID WHOLESALE ENERGY CONTRACTS UNLESS THE CONTRACT IS CAUSING EXTRAORDINARY DAMAGE TO THE PUBLIC INTEREST

The Solicitor General suggests that the possibility of ultimate agency affirmance counsels against this Court granting review now. U.S. Opp. at 18, 22. The remand ordered by the court below, however, itself undermines the contract stability critical to the wholesale energy markets.

What the Solicitor General ignores is the fundamental difference between the certainty of contract stability based on re-

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[1] *See* Snohomish Br. in Opp. at 1 ("The Ninth Circuit remanded the case and left substantial discretion to FERC, which, *accordingly*, has not petitioned for review.") (emphasis added). *See also* Int'l Swaps & Derivatives Ass'n, Inc. ("ISDA") *et al.* Amici Br. at 15 ("Regulatory agencies cannot be expected to oppose the assertion that they should have more discretion, rather than less, to judge on a case-by-case basis whether the operation of market forces will adequately protect the public interest, especially if more discretion permits the agency to offer visible, short-term benefits to discrete groups of consumers.").

spect for the market pricing mechanism and the possibility of contract stability based on federal agency discretion. A well-functioning market requires predictable rules about the future, including the certainty that (absent extraordinary circumstances) valid agreements entered into today will be upheld tomorrow. *Mobile* and *Sierra* provided such rules, and the energy market has flourished as a result. But the Ninth Circuit has now shifted the regulatory regime from one of certain contract stability to one of possible contract stability. Agency policy can and does change, and there is no guarantee at all that FERC will always uphold contracts like this one.[2] The remand ordered by the court is a remand that itself eliminates the predictability of contract stability, regardless of the agency's ultimate conclusion.

Ironically, the circumstances that the Ninth Circuit cited as warranting a remand to FERC are precisely the circumstances that most warrant respect for negotiated agreements. As our opening petition explains, long term agreements are an important mechanism by which participants in the energy markets protect themselves against high spot prices. Pet. at 20-21. During an energy crisis in the spot market, an important solution is for buyers to enter into longer term agreements and thereby minimize exposure to future increases in energy prices. Pet. at 29. The Ninth Circuit, however, has compelled FERC to re-examine this long term contract *because* it was entered into during a time of energy volatility in the spot mar-

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[2] *See* ISDA Amici Br. at 16 ("The risk that contract rates may be modified – if not by FERC as currently constituted, perhaps by FERC when it is controlled by different commissioners; if not these contract rates, perhaps the rates that will be negotiated when prices rise again; if not because of this market 'dysfunction,' perhaps because of another – is a risk that market participants must reckon with, regardless of FERC's immediate response to the decisions."); Electric Power Supply Ass'n ("EPSA") *et al.* Amici Br. at 16 ("the Commission cannot unilaterally repair the damage because uncertainty will continue to loom over the industry").

kets. Thus, the remand ordered here turns the circumstances of energy shortage into a reason for FERC to reevaluate an agreement, thereby undercutting the confidence of sellers that long term contracts entered into when demand for spot power exceeds supply will be honored, even though that is the circumstance when long term agreements are most needed.

Furthermore, the particular type of remand ordered by the Ninth Circuit compounds the problems the remand causes. As the Solicitor General concedes (and indeed treats as a *virtue*), the court below "has not restricted the Commission's ability, on remand, to consider all relevant facts in its analysis." U.S. Opp. at 18. But market participants cannot predict the outcome of an "all relevant facts" agency inquiry. To the contrary, the remand ordered here grants FERC the type of unfettered regulatory discretion that is the death-knell of the reliable rules all markets require. See Frank Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1, 12 (1984) ("When everything is relevant, nothing is dispositive. . . . [A multi-factor] formulation offers no help to businesses planning their conduct.").

In short, regardless of the agency's eventual remand ruling, the Ninth Circuit's decision to grant FERC plenary authority to evaluate negotiated wholesale energy agreements makes such agreements far less reliable. The damage done by the decision below warrants immediate review.

## II. THE NINTH CIRCUIT'S DECISION IS IN DIRECT CONFLICT WITH *MOBILE* AND *SIERRA*

The Solicitor General's attempt to minimize the breadth of the Ninth Circuit's opinion is unavailing.

1. The Solicitor General claims we "greatly overstate the breadth" of the opinion below. U.S. Opp. at 11. Similarly, the government hopes that some "improvements in FERC's market oversight" (U.S. Opp. at 13-16) might satisfy the Ninth Circuit. See U.S. Opp. at 14 (court's rejection of FERC's

market-based regulations "primarily of historical interest").[3] This is not a tenable reading of the opinion. The decision below, for example, highlights that the respect for market pricing endorsed by *Mobile* and *Sierra* occurs only "*in certain circumstances.*" Pet. App. at 9a (original emphasis). Although the court then allows that the respect for market pricing compelled by *Mobile-Sierra* is "not" (yet) "a dead letter," the court then explains the "limited circumstances" in which the principles of *Mobile* and *Sierra* apply, admitting that "no case has outlined these conditions succinctly." Pet. App. at 37a. Consistent with its prior rhetoric, the court below allows market agreements to have force "*only*" when FERC has an "effective oversight mechanism." Pet. App. at 48a (original emphasis, second emphasis removed).

Indeed, the precise conditions that the Ninth Circuit outlines for respecting market agreements are in practice insurmountable. To be sure, the decision below does not go so far as to declare that every conceivable oversight regime will be insufficiently "effective," indicating that "market-based rate authority *may* be a tenable choice" if accompanied with "sufficient oversight." Pet. App. at 57a (emphasis added). But the court's suggestion that some unspecified revision of FERC's market-based regime "may" at most be a "tenable" choice indicates the court's hostility to prices set by contracts. In this case, of course, FERC's regulatory mechanism was – with the

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[3] In many respects, the Solicitor General's efforts to avoid review here mirror his unsuccessful recent effort to avoid review in *Environmental Defense v. Duke Energy Corp.*, 127 S. Ct. 1423 (2007). There, the Solicitor General opposed review on the basis of "proposed new [] rules for electric generating units" that rendered the "proper interpretation of the [prior] regulations" "of limited practical import now." U.S. Opp. to Pet., No. 05-848, 2006 WL 575231, at *7-*8 (filed March 8, 2006). Just as the "practical import" of the regulations in place at the time of the dispute in *Duke Energy* were sufficient to warrant this Court's review, the regulations in place in 2000-2001 – many of which remain in place today (see U.S. Opp. at 4) – retain ample contemporary interest to warrant review.

benefit of hindsight – declared ineffective by the court. Pet. App. at 49a-51a. In view of the tenor of the opinion and the hindsight method of evaluating FERC's existing scheme, as a practical matter there is at least significant doubt that the Ninth Circuit will ever conclude that FERC has sufficiently effective oversight to warrant respecting market agreements.

2. The Solicitor General suggests that the decision below "appl[ies] the principles of *Mobile* and *Sierra* to the highly unusual context of the 2000-2001 western energy crisis." U.S. Opp. at 12. The Solicitor General agrees with us that the "*Mobile-Sierra* doctrine" "rests on the assumption that '[i]n wholesale markets, the party charging the rate and the party charged were often sophisticated businesses enjoying presumptively equal bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the two of them.'" U.S. Opp. at 8, quoting *Verizon Commc'ns, Inc. v. FCC*, 535 U.S. 467, 479 (2002). Contrary to the Solicitor General's suggestion, however, the events in 2000-2001 were not so unusual as to warrant a departure from the contract-respecting principles of *Mobile* and *Sierra*.

First, FERC has already concluded that the *long term* wholesale energy market functioned properly during the western energy crisis. FERC found, and the Ninth Circuit did not dispute, "that the spot and forward markets can and should be analyzed separately," Pet. App. at 59a n.26, and that "there is nothing in the record" to support a finding of "market manipulation *specific to* the long term contracts at issue here." Pet. App. at 301a (original emphasis). Since the forward market was well-functioning, any dysfunction in the spot market was a fact about the world that both petitioner and respondent were free and able to take into account when agreeing to this long term contract. Pet. at 23.

Second, and despite FERC's efforts, there will inevitably be other periods of extreme energy price volatility. Our petition sketches some reasons, including the difficulty of storing

power, the unpredictability of consumer demand due to weather conditions, and the long horizon for building infrastructure. Pet. at 28-29. See also EPSA Amici Br. at 8 ("industry often faces large, sudden shifts in price"). Though the specifics are of course impossible to predict, that future energy crises await us is foreordained. Thus, an exception based on the market circumstances of 2000-2001 cannot possibly be limited to just that time frame but will inevitably lead to undoing market-based agreements at other times in the future. See *e.g.*, Pet. App. at 220a ("In the past, the Commission has enforced the parties' bargains in similar circumstances.").

In view of the inevitability of future severe changes in energy market circumstances, the changed market conditions in *Sierra* are indeed "comparable" (U.S. Opp. at 23) to the changed market conditions facing the parties here. In both instances, objective and well-known market conditions resulted in significant changes to energy prices. Although the degree of change may differ, the fundamental economic principle of *Mobile* and *Sierra* is directly at issue here: absent extraordinary damage to the public interest, valid wholesale energy agreements are to be enforced despite sharp changes in market circumstances.

3. In another effort to minimize the breadth of the decision below, the Solicitor General notes purportedly qualifying language in the opinion stating that not "*any* direct impact on consumer rates" is sufficient to warrant invalidation under the Ninth Circuit's expansive understanding of the *Mobile* and *Sierra* "public interest" basis for altering a contract. U.S. Opp. at 20 (original emphasis). There is, however, much opinion language to the contrary. See, *e.g.*, Pet. App. at 64a ("even a small dent in the consumer's pocket is relevant") (quotation marks omitted). More important, the court below has ordered FERC to consider invalidating this contract based on the "public interest," even though the court expressly acknowledged that the agreement only "accounted for an eight percent in-

crease," Pet. App. at 65a, an increase that FERC has already explained "arguably actually resulted in rate relief" given what respondent had anticipated charging. FERC Ct. App. Br., No. 03-74208, 2004 WL 2682046, at *116 (filed Sept. 23, 2004). By holding that FERC can use the public interest exception to invalidate a contract with little if any adverse consumer effect, the court below has converted *Mobile* and *Sierra*'s narrow public interest exception into a blank check for agency contract invalidation.

In a related effort to down-play the opinion, the government claims that "FERC has already demonstrated that, in applying the principles of the court's decision[], it will protect contractual stability." U.S. Opp. at 22, citing *CAlifornians for Renewable Energy, Inc. v. California Pub. Utils. Comm'n*, 119 F.E.R.C. ¶ 61,058 (2007). But the key difference is that under the decision below FERC can also choose *not* to uphold the contract. Under *Mobile* and *Sierra*, only if a contract is causing extraordinary damage to the public – akin to the closing of a public utility – can FERC void a valid energy contract. See Pet. at 12-15. A "trust me" statement from a regulatory agency cannot and will not provide the level of assurance companies need when deciding whether long term contracts are secure enough to justify staking very large amounts of money on those contracts. The protection of *law* – not agency discretion – provided by this Court's *Mobile* and *Sierra* decisions is the only assurance sufficiently reliable to encourage entry into long term contracts in times of crisis, when they are most important.

Furthermore, our petition (at 24) explained that the Ninth Circuit's public interest holding creates a one-way ratchet, where purchasers but not sellers can take advantage of the court's broad understanding of public interest. See also Amicus Br. of Interstate Natural Gas Ass'n of Am. at 7-12. In that regard, the decision conflicts with decisions from other circuits applying the same standards to both purchasers and

sellers. See *Potomac Elec. Power Co. v. FERC*, 210 F.3d 403, 409 (D.C. Cir. 2000), and *Boston Edison Co. v. FERC*, 233 F.3d 60, 66 (1st Cir. 2000). The government suggests that there is no circuit conflict because *Potomac Power* and *Boston Edison* do not involve either market-based rates or a power crisis. U.S. Opp. at 24. But neither of those distinctions would warrant treating a sophisticated seller differently from a sophisticated purchaser, both of whom were well aware of the market-based rates and energy market conditions. More fundamentally, the Solicitor General suggests that the decision below is not "biased against sellers," U.S. Opp. at 21, implying that all parties can now take advantage of the Ninth Circuit's relaxed form of FERC review for public interest. But even if that characterization of the decision below were accurate, that would merely make its conflict with *Mobile* and *Sierra* still more significant, as those cases forbid FERC from undoing negotiated agreements so easily.

## III. THE DECISION OF THE NINTH CIRCUIT REQUIRES IMMEDIATE REVIEW BECAUSE IT IS SEVERELY DISRUPTING THE NATIONAL ENERGY MARKETS

The Solicitor General's brief also confirms by omission the exceptional importance of this case. Our opening petition emphasized the critical role of valid long term contracts in helping to minimize the costs caused by the next, inevitable, period of energy price volatility. Pet. at 28-29. We also emphasized the decreased investment in crucial energy infrastructure that the decision below will cause. Pet. at 25-26. Tellingly, the Solicitor General nowhere attempts to minimize the exceptional importance of this case. As the largest financial trade association in the world explains, "the Ninth Circuit's decision[], if allowed to stand, will lead to market dysfunction that will impose enormous costs on the American public." ISDA Amici Br. at 2-3. Accord EPSA Amici Br. at 3 (decision below will "impose billions of dollars of unnecessary costs on consumers").

* * *

The Solicitor General's case against granting certiorari essentially comes down to an argument that FERC might get it right on remand. But that cannot happen. To be sure, FERC might well sustain the contracts at issue in this case, as it should. But it will do so in the fashion of the proverbial broken clock that fortuitously tells the right time twice a day. That is, FERC will not sustain the terms of these contracts on the simple, correct basis that they are the terms at which sophisticated buyers and sellers were willing to buy and sell, but rather because those terms result from FERC's post-hoc consideration of "all relevant facts." U.S. Opp. at 18. That process, mandated by the court below, is seriously destabilizing whether the FERC process happens to result in the same or in a different set of terms than the contracting parties had achieved through bargaining and agreement. For this reason, the Ninth Circuit's essential decision that contract terms are not binding cannot be corrected on remand. That decision is a serious mistake that can only be corrected by this Court and it needs to be corrected now.

## CONCLUSION

For the foregoing reasons and those previously stated, the petition should be granted.

Respectfully submitted,

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